

Collateral Assessment in Crediting by Banks. Evidence from Uzbekistan

Abdikarimova Dinara

Researcher of the department of Financial Management, Tashkent Financial Institute
 60A, Amir Temur street, Tashkent, Uzbekistan

Abstract

At present one of the common means to attract funds in business is to get loan from commercial banks. Obviously, in most countries interest on debt capital is tax deductible. Therefore, debt capital cost lower than equity in some cases. But, in order to prevent the risk, banks also give credits under certain conditions. In the first decade of 20th century, the first stage of crediting was easier than now in Uzbekistan. Thus, banks had some difficulties with getting their funds back, because some enterprises went bankrupt because of financial crisis and the market value of the collateral was not enough to cover the debt. Taking all of those situations into considerations, banks are paying a great attention to the collateral assessment. Nevertheless, there are still some problems that need solutions. This paper studies the current state of collateral assessment in Uzbekistan and gives some recommendations and proposals to improve it.

Keywords: Collateral, assessment, bank loan, estimation institution, Uzbekistan

1. Introduction

The improvement of market relations and economic reforms in Uzbekistan requires the development of different types of financial institutions. Assessment institution is one of those institutions. Establishment of assessment institutions in Uzbekistan is directly linked to the early years of independence of Uzbekistan.

Establishment and emergence of various forms of ownership in Uzbekistan created the necessity of identifying real market prices by independent appraisal of their assets, which was the basis of the activity of the assessment institutes in the Uzbekistan. In the market economy the necessity to assess the value of movable and immovable, tangible and intangible assets appear in the social and economic relations such as selling, buying, investing them and using them as collateral in crediting. Before the independence of Uzbekistan, there was no need to evaluate movable and immovable property and tangible and intangible assets, because all the country's enterprises and organizations, the tangible and intangible assets of the production used to be under the control of the state, sale, purchase, lease and other relationships were strictly determined by the state control.

According to our study, we can claim that theoretical issues related to the formation and increasing effectiveness of collateral assessment have not been studied by economists, researchers and specialists. The main reason for this is that the establishment and development of assessment institutes does not have a long history.

Nevertheless, in the last years much attention has been paid to the assessment of collateral in crediting. Therefore, many people who are willing to get bank loans are trying to use the service of assessment agencies. The value of the evaluated object is not consistently sustained as a result of the impact of market and competition factors, because the prices of movable or immovable property on the market are constantly changing as a result of the demand and flexibility of the supply. An agency that evaluates the collateral of a bank loan should have clear evidence and grounds for the effectiveness of the object being evaluated. The essence of the matter is that the real selling price of an object valued by the loan security will be determined in the future. The aforementioned cases, as well as the development of credit relations in the banks, have led to the need to determine the economic content and basic principles of the collateral's assessment. The market value of the property, which the bank considers to be a mortgage, is important, and this process necessitates the need to assess the collateral of banks. Hence, we can rely on the above-mentioned cases that three parties will take part in the process of assessing the collateral in the bank loan, as shown in the figure below.

Figure 1.



Figure 1. Parties participating in the Bank's collateral assessment

Source: Authors compilation

The party of the start up process and the focus of the relationship is the borrower. The Borrower shall furnish to the Bank, as collateral, his or her movable or immovable assets according to the request of the Bank to meet its financial requirements. It is the process that builds up the assessment and building relationships. Of

course, this process is regulated and arranged on the basis of a contract between a lender and an assessment organization.

It is well-known that first of all, it is necessary to invest in the development of business. Because, entities may find it hard to develop their activities only using their equity in the conditions of competition. Taking into account these aspects, the entity tries to obtain a loan. One of the stages of obtaining a loan is the collateral estimation. Before crediting the enterprise, the item to be provided for the collateral should be assessed. As a result, there is a need to estimate the real value of collateral objects. Based on the report provided by the expert, banks may conclude about the liquidity and value of the object taking into account the market conditions and the investment attractiveness of the object.

Through the involvement of the valuation specialists, the following tasks will be performed during the lending process:

- Assessing assets to provide loans to corporate clients;
- Determination of value of property for mortgage lending;
- evaluation of the debtor's property for sale in case he or she does not repay the loan;

One of the peculiarities of valuation in the process of lending is the participation of three parties - banks, borrowers and valuation experts. It is important to identify the true value of the property being delivered as collateral for the Bank and the precise assessment of the credit risk. If the borrower seeks to obtain the maximum amount of credit by giving his own assets as collateral, the appraiser's task is to determine the "golden point" between the client's needs and the bank's requirements. Determining the real market value of the supply will allow the fairness of the relationship between the value of the collateral and the amount of loan.

At the same time, it will also serve to prevent disagreements between the parties in the process of crediting. As shown in the report, the report presents the approximate value of the valuation object and its liquidity value. In addition, a number of banks are asking the appraiser to include a report showing the changes in the value of the object during crediting. The main criterion for evaluating any property is an analysis of its effectiveness.

Aside from the valuation of banks, the valuation company offers another service. This service is an expertise service to determine whether there is a difference between the price presented in the conclusion and its market price.

At the next stage, a inquiry will be written and sent to the credit department of the bank on how well the report has been made.

Credit risk management in developed countries

In each country worldwide, every bank wants to secure its loans and tries to minimize the riskiness of its credit portfolio. Therefore, they use different approaches and methods in order to minimize risks. There are several options of credit risk management.

Screening and Monitoring

Asymmetric information is present in credit markets, as creditors have less information about investment opportunities and activities of borrowers than borrowers. This situation leads to two information activities conducted by financial institutions - screening and monitoring.

Long-Term Customer Relationships

An additional way for managers of financial institutions to obtain information about their borrowers is long-term interaction with customers, another important principle of credit risk management. If a potential borrower has a checking or savings account or other loans in a financial institution for a long period of time, the loan officer can look at past activity in the accounts and learn a little about the borrower.

Loan Commitments

Banks have a special mechanism for institutionalizing long-term relationships with customers, called loan commitments. A loan commitment is an obligation of a bank (for a certain future period of time) to provide a firm with loans up to a certain amount with an interest rate tied to a certain market interest

Collateral

Collateral requirements for loans are important credit risk management tools. Loans with these collateral requirements are often referred to as **secured loans**.

Credit Rationing

Another way in which financial institutions cope with adverse selection and moral hazard is lending: the refusal to provide loans even if borrowers are willing to pay the specified interest rate or even a higher rate.

Literature review

Existing research (Brevoort and Hannan, 2004; Dell'Ariccia and Marquez, 2004; Hauswald and Marquez, 2006; Presbitero and Zazzaro, 2010) documents that local banks tend to lend on a relational basis to local applicants over which these banks have a fundamental information advantage in order to create a competitive wedge against distant, transaction rivals. Thus, relationship variables would be partly influenced by the structure of the

local credit market and their possible negative impact on collateral would be a less precise reflection of the lender-based theory. In addition, to the extent that collateral requirement is a costly alternative to ex ante screening (Manove et al. 2001), repeated lending and collateral might be inversely related even if collateral is motivated by adverse selection or moral hazard problems (Boot and Thakor 1994; Karapetyan and Stacescu, 2015). Thus, a test of the lender-based view using such variables might lead to instances of false positive errors. Relationship-based variables might also reflect hold-up problems and softbudget-constraint effects that could have a positive relationship to both collateral requirements and loan rates (Ono and Uesugi, 2009), thus preventing us from rejecting the lender-based theory, i.e. leading to false negative type of errors. Finally, the nature of the lending relationship has a less clear impact on the monitoring and liquidation costs of collateral and thus does not allow us to gain insights into the relevance of the borrower-based view of collateral

Methodology

There are different estimation agencies in the Republic of Uzbekistan. They determine the value of the asset that is going to be shown as collateral for bank loans. We will see how “VALUATION AND CONSULTING CENTRE” LLC estimates the coordinated/final value of an asset i.e. car of the person who is willing to get bank loan.

Selection, application of estimation approaches and methods.

In determining the valuation of an object, the estimator uses revenues, costs, and comparative approaches.

Cost Approach:

Assessment of the vehicle is based on the calculation of the physical depreciation of the cost of creating or replacing a specific copy of an object of evaluation.

Calculation of the cost of vehicles in the cost approach is carried out in the following sequence:

- a) Determining the estimated recovery value or the replacement value;
- b) Determining physical depreciation;
- c) Calculation of market value.

The estimated recovery value is calculated using one of the following methods:

- direct method of price determination;
- method of calculation of the cost of related object;
- index method.

Revenue Approach: It is underscored that, according to the requirements of the National Property Standards of the Republic of Uzbekistan, the valuation of cars, equipment, vehicles and intangible assets, as well as other movable property, is not assessed using revenue approach

Comparative Approach:

Estimation of the value of motor vehicles with a comparative approach is made using the direct analogue method of comparing market prices. Comparison:

with an absolute analogue sold on the secondary market;

without analogous analogue, by introducing corrections with the analogue sold on the secondary market;

If there is no secondary market, it will be implemented through a new similar vehicle

Estimation of the cost of vehicles by direct analogue method is carried out in the following sequence:

- a) analysis of the analogue market;
- b) the selection of the appropriate comparison units;
- c) identifying suitable comparative elements;
- g) to make adjustments to the differences between the evaluation object and analogue;
- d) calculate the final value of the evaluation object.

Calculation of the final value of an object

The final value of the object of evaluation shall be determined by the following formula:

$$K_{final} = K_{cos} * C_1 + K_{rev} * C_2 + K_{comp} * C_3$$

Here:

K_{final} - The final value of the estimated object;

K_{cos} , K_{rev} , K_{comp} - the values determined by cost, revenue and comparative approaches respectively;

C_1 , C_2 , C_3 - the corresponding specific dimensions selected for each evaluation approach.

The following requirement must be met:

$$C_1 + C_2 + C_3 = 1$$

The coordination of the vehicle estimation results is illustrated in the table below: (Figure 1)

State registration number 01 G 250 UA with SPARK motor vehicle:

Approaches	Cost approach (K_{cos})	Revenue approach (K_{rev})	Comparative approach (K_{comp})
Determined value	29 419 209 UZS	Not used	29 109 829 UZS
<i>The formula to find the specific measurements of coefficients</i>	$C_1 = \frac{K_{cos}}{K_{cos} + K_{rev} + K_{comp}}$	$C_2 = \frac{K_{rev}}{K_{cos} + K_{rev} + K_{comp}}$	$C_3 = \frac{K_{comp}}{K_{cos} + K_{rev} + K_{comp}}$
Measurement coefficients	$C_1 = 0,503$	$C_2 = 0,0$	$C_3 = 0,497$
Measurement values	14 787 358 UZS	0	14 477 978 UZS
<i>formula for finding coordinated/final value</i>	$C_1 + C_2 + C_3$		
Coordinated value	29 265 337 UZS		

Figure 1. The final process of determining coordinated value of State registration number 01 G 250 UA with SPARK motor vehicle:

Source: The report of “VALUATION AND CONSULTING CENTRE” LLC

Conclusion

As a result of research carried out within the framework of the banks' collateral evaluation, we have compiled the following conclusions and recommendations:

- In the development of the national standards for valuation, it is necessary to extend the involvement of the Association of Valuation Organizations to develop an association's relationships with international evaluators and foundations, and to exploit its experience in the field of internationally-recognized practices;
- Under conditions of market economy one of the main conditions of elimination of financial risks of commercial banks and reduction of credit risk is collateral and its fair evaluation
- The estimation institutions should pay particular attention to factors such as time factor, risk factor, market factor, competitive factor, factors of valuation of the valued object in assessing the collateral of banks' loans;
- The assessment of the object evaluated directly and indirectly affects the degree of its usefulness, the value of the human intellectual and physical labor and the level of socio-economic development of the region in which the property is located and its infrastructure;
- The comparative approach relies on market and real-estate reviews of movable or immovable property being evaluated. In this assessment approach, the price of the object being evaluated is similar to the market price of movable or immovable property;

References

1. Frederic S.Mishkin and Stanley G.Eakins. Financial Market and Institutions. Seventh edition. 2012. Pages 569-572
2. Abdukarimov B.A. . Business Economics. Textbook. -T.: Fan, 2005.
3. V. P. Karpenko, A. A. Slutskiy Оценка залога при кредитовании: некоторые проблемы и пути их решения. Scientific article. Деньги и кредит 1/2012
4. Business valuation. Textbook. The second edition is revised and supplemented. Edited by Gryaznova AG, Fedotova MA -M.: "FiS", 2004;
5. Andrea Bellucci, Alexandr Borisov, Germana Giombini, Alberto Zazzaro. Collateral and Local Lending: Testing the Lender-Based Theory. Working Paper Series No.21. June, 2015. Pages 3-5
6. Hodiev B., Berkinov B., Kravchenko A. Evaluation of business value. textbook. -T.: "Economics and Finance", 2007
7. <http://uzbkm.uz/ru/> the website of “VALUATION AND CONSULTING CENTRE” LLC